EM Watch

INFLATION & TRADE RELATIVE VALUE

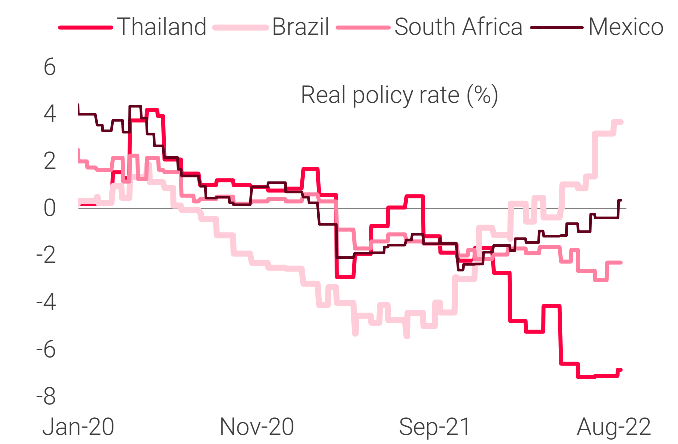
Jon Harrison

- **EM face heightened external risks and weaker fundamentals**
- **EM are divided along lines of inflation and trade dynamics**
- **We add a long Brazil vs short South Africa equity trade**

Fed tightening remains a risk to EM assets. Recent US housing data may indicate a slump, but increasing employment and improving manufacturing production among other factors point to a probability of a more aggressive pace of Fed tightening that is not yet priced into markets and will ultimately lead to a Q4/22 recession (see our 17 August Daily Note). The severity of the recession and the scale of damage to US financial markets remain uncertain (see our 17 August Macro Strategy). EM equities will inevitably falter in the event of a US market correction, while currencies will be vulnerable to a stronger dollar unless external headwinds are countered by higher interest rates, solid trade balances or other robust drivers of inflows.

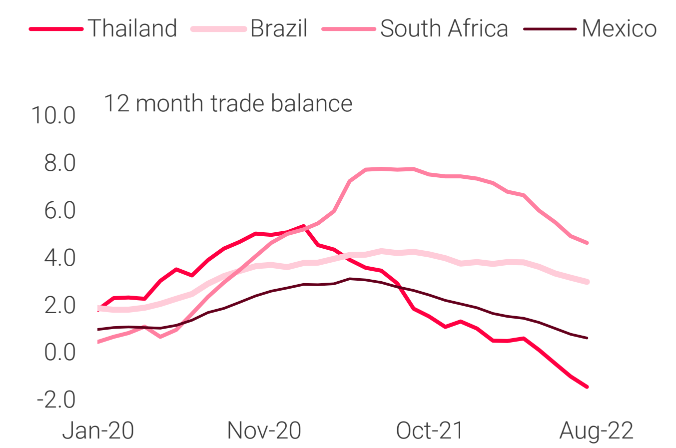
EM central banks' responses vary. The central banks of Brazil and Mexico continue to stand out among EM in raising real policy rates aggressively in an effort to combat inflation (see Chart1). In both of these, core inflation is starting to decelerate, and we expect headline inflation to peak in the coming months in marked contrast to many EM in which inflation is surging higher still. By contrast in South Africa, core inflation is accelerating while the SARB faces structural constraints on economic growth that limit its willingness to raise interest rates. Negative real interest rates will provide little defence for the rand as the dollar appreciates. Thailand has among the most extreme negative real rates. The Bank of Thailand delayed the start of the tightening cycle until August, plunging real interest rates deep into negative territory.

Chart 1: EM real rates are bottoming out



Source: Bloomberg, TS Lombard.

Chart 2: EM trade balances are deteriorating



Source: Bloomberg, TS Lombard.

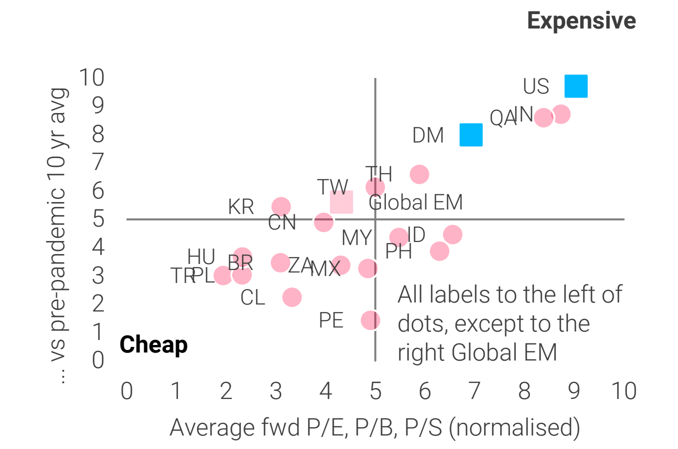
EM face differing pressures on exports. The collapse of China's imports owing to zero Covid and the property sector is evident in the exports of Asian manufacturing economies, including South Korea and Thailand (see our 16 August chartbook EM face China fallout). Thailand has suffered one of the most precipitous deteriorations of trade balance among EM economies (see Chart 2). By contrast, Brazil has maintained a solid trade surplus despite a strong consumer recovery that has fuelled imports. South Africa too has maintained a trade surplus, but year on year exports have contracted in each of the 3 months to June, while imports have continued to recover. The power sector crisis, risk of industrial action and infrastructure limitations will further constrain exports and weigh on the economy.

As of today, we close our long USD/THB trade with a total return profit of 4.6% (see Table 2). The direction of travel for the real policy rate in Thailand has turned in favour of the baht, although tightening appears likely to be limited. Of greater significance for investors, however, is the growing tourist revival. Tourist arrivals surged in July, reaching 32% of that for the same month in 2019, compared with 25% of 2019 in June. The prospect of a further revival of the tourist industry could be sufficient to stem the depreciation of the baht, although downside risks from interest rates and manufacturing exports remain. The full recovery of the tourist sector to pre-pandemic levels will depend on the re-opening of China.

Falling prices are a risk to EM commodity exporters. Energy prices look set to remain elevated, while the prices of agricultural and industrial commodities have fallen significantly from earlier highs and face the risk of further downside as the global slowdown deepens. Stimulus measures in China could ultimately provide some support for commodity prices, but we do not expect this to be a significant factor until H1/23 at the earliest. In the meantime, commodity price risks are biased to the downside.

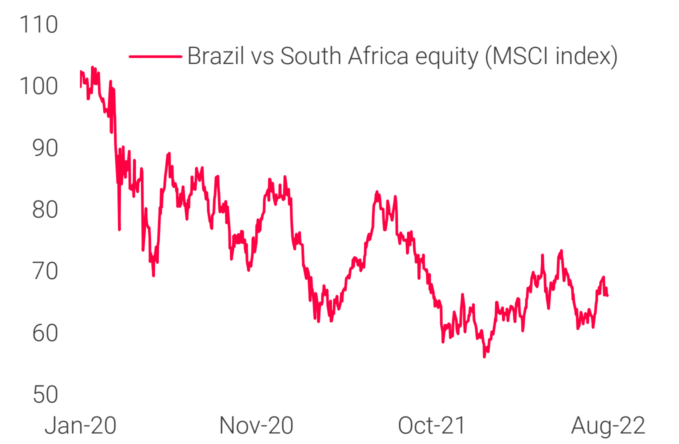
As of today, we add a long Brazil vs short South Africa equity index trade to our list of Absolute Views (see Table 1). Inflation and trade dynamics are likely to be among the most important factors distinguishing EM equity winners from losers. Brazil stands with regards to inflation and the equity market is our top EM asset allocation call (see our 15 August EM Strategy Monthly). Trade dynamics in Brazil will depend to an extent on commodity prices. We hedge the commodity exposure by pairing a long Brazil equities position with short South Africa. Both Brazil and South Africa are relatively cheap, though Brazil marginally more so, while Brazil has underperformed South Africa during the pandemic and post-pandemic recovery (see Charts 3 and 4).

Chart 3: Many EM equities remain cheap



Source: Bloomberg, TS Lombard.

Chart 4: Brazil has underperformed South Africa



Source: Bloomberg, TS Lombard.

MUST READ

Brazil: The outlook remains challenging

The Bolsonaro administration has boosted social spending and approved massive tax cuts ahead of the October election in a bid to increase the President's chances of being re-elected. Wilson Ferrarezi and Elizabeth Johnson explain that increased fiscal spending will continue to boost the recovery in H2/22, but the outlook for next year remains challenging and the economy is set to slow into 2023. While Lula is still ahead in the polls, his lead could narrow as more families benefit from social spending – Bolsonaro's rejection rate is key to monitor. See our 17 August report Recovery continues in H2, but 2023 outlook remains challenging.

China: Timing the Covid cycle

For China, Covid-19 remains the dominant macro and market variable. April and May will be the nadir in activity this year, but the recovery is going to be sluggish as long as "zero Covid" weighs on the economy. Rory Green explains that politics, healthcare and Hong Kong all point to a mid H1/23 material easing of pandemic restrictions. Until then, China activity, stimulus efficacy and markets will disappoint. See our 15 August report Timing China's Covid cycle.

ASSET ALLOCATION

We present below our EM asset allocation view.

We will publish our next Asset Allocation view on 19 September.

Asset Allocation view

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	-1			
Asset class	-1	-1	+1	0
Relative country views				
China	0	0	+1	n/a
Brazil	+2 (+1)	+1	+1	-1
India	+1	-1	-1	n/a
Mexico	-1	+1 (0)	+1	+1
Indonesia	+1	+1	-1	+1
Philippines	-1 (+1)	-1 (+1)	+1	+1
Thailand	+1 (-1)	+1 (-1)	0	n/a
South Africa	-1	-1 (0)	-1	-1
Turkey	-2 (-1)	-1	-1	-1

Scale
+2
+1
0
-1
-2

Last month in brackets

Source: TS Lombard. The scores for our relative country views sum to zero in each column. See methodology.

ABSOLUTE VIEWS

Table 1: Current Absolute Views

Asset		Long Short	Date Opened	Units	Open Level	Current Level	Total Return ($)
ID vs MX	Equity	Long	6-Dec-21		9.348	9.654	+3.3%
USD/BRL		Short	28-Mar-22		4.765	5.170	-3.7%
EM index	4:1 Debt vs Equity	Long	6-Jun-22		100.00	99.23	-0.8%
China index vs CD	Equity	Long	4-Jul-22		32.82	34.36	+3.9%
China	Local debt	Long	25-Jul-22	%	2.63	2.48	+0.4%
USD/INR		Long	25-Jul-22		79.74	79.87	-0.1%
USD vs KRW, TWD		Long	1-Aug-22		100.00	101.59	+1.6%
BR vs ZA	Equity	Long	22-Aug-22		18.07	18.07	0.0%

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Source: Bloomberg, TS Lombard.

Closed views are in Table 2, below. Intra-day prices used for views that are opened or closed on the date of publication are modified to the close of business prices in subsequent reports. For further explanation, see our methodology.

Closed Views

Table 2: Closed Absolute Views

Asset		Long Short	Date Opened	Date Closed	Open Level	Close Level	Total Return ($)
USD/BRL		Short	16-Nov-20	7-Jun-21	5.430	5.046	+8.9%
Brazil	Local debt	Long	24-May-21	14-Jun-21	7.62	7.58	+5.8%
Thailand	Local debt	Short	28-Jun-21	2-Aug-21	1.671	1.520	+1.2%
Indonesia	Local debt	Long	1-Mar-21	9-Aug-21	6.323	5.941	+4.4%
EM ex-CN vs CN	Equity	Long	4-May-21	23-Aug-21	289.35	355.12	+18.5%
PHP/IDR		Short	7-Dec-20	11-Oct-21	293.33	279.77	+6.1%
ID CD vs EM	Equity	Long	2-Aug-21	8-Nov-21	1.623	2.049	+25.7%
Russia	Equity	Long	28-Jun-21	28-Feb-22	791.1	325.4	-58.9%
Philippines	Local debt	Long	8-Nov-21	28-Mar-22	3.991	4.978	-6.2%
USD/INR		Long	28-Mar-22	16-May-22	76.17	77.38	+1.4%
USD/CNY		Long	31-Aug-21	25-Jul-22	6.461	6.751	+1.4%
USD/THB		Long	3-May-22	22-Aug-22	34.35	36.02	+4.6%

Source: Bloomberg, TS Lombard.

Levels are for London close of business, obtained from Bloomberg. Intra-day prices used for views that are opened or closed on the date of publication are updated to the close of business prices in subsequent reports.

For further explanation, see our methodology.

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